EMERALD

Emerald Advisers, Inc.
2009 3rd Quarter Economic & Portfolio Commentary

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Market & Economy Gaining Traction

	3rd Quarter 2009
Russell 2000 Growth	15.95%
Russell 2000 Value	22.70%
S&P 500	15.61%

The recovery continues to gain traction. In recent weeks, Ben Bernanke, the Chairman of the Federal Reserve, declared that he believed from a technical standpoint that the recession is very likely over, echoing the sentiments of many economists, and confirming what the manufacturing index has already been telegraphing. September's industrial production showed further improvement, gaining 0.7%, well above the 0.2% anticipated, and August was revised up. Capacity utilization continues to expand and now stands at 70.5%. While industrial production is rebounding aggressively, the V-shaped recovery that is being witnessed in the manufacturing sector has yet to translate to the rest of the economy, particularly the consumer.

That being said, the third quarter did have some pleasant and unexpected surprises. Cash for Clunkers sparked new car sales to such a degree that many economists were forced to rethink their estimates for GDP growth for the third and fourth quarters. Home sales are improving, driven by the tax credit for home purchases as well as the Fed's purchase program of mortgage-backed securities which has kept mortgage rates low. New home inventory is declining and is now seven months down from the peak of twelve months. While the housing market is not out of the woods yet, particularly as foreclosures and the reset of adjustable rate mortgages loom, it is experiencing more improvement than even the most optimistic economist thought possible just a mere quarter ago. This has created a positive feedback loop for the consumer. September retail sales showed some signs of life, and early October commentary has been incrementally more positive. Employment, or the lack there of, remains the largest source of uncertainty and consternation. While in our due diligence and conversation with various management teams, Emerald has come across some anecdotal evidence of a willingness to rehire; we lack visibility as to the timeframe and the trajectory of these hiring initiatives. Therefore, while we believe year over year sales trends will show improvement as we move through the holiday season, in part due to easier compares, the magnitude of the improvement remains unclear. The good news is that expectations for holiday are bleak by historical standards with estimates ranging from up 1% to down 2%. Given the consumer's contribution to the economy, Emerald continues to monitor this aspect with great interest.

While the level of unemployment has limited the improvement in consumer confidence, confidence in the corporate suite appears to be rebounding more aggressively driven by both a rising stock market and improving economic outlook. The Conference Board Measure of CEO confidence recently released September survey results which indicated that CEO's have grown more optimistic in their short-term outlook. This increased confidence is most evident in the acceleration in merger and acquisition activity witnessed during the third quarter. Flush with cash and a new found confidence, corporations seemingly have been making their shopping lists. Most notable were Disney's acquisition of Marvel Entertainment (an Emerald holding), Dell's acquisition of Perot Systems and Cisco's multi-week buying spree in which the company proposed to acquire both Tandberg and Starent Networks. Importantly, not only were the CEOs of these acquiring companies confident enough to propose the acquisition, but in each case they did so at premiums to the market price, and in some cases by a substantive amount, implying that valuations remain attractive.

This increasing confidence should also bode well for corporate earnings. Second quarter earnings were better than expected and early indications from the likes of Intel, Apple, and Google are that third quarter earnings and fourth quarter guidance will be even better than what was reported exiting the second quarter. The question in the short-term, however, is how much is already imputed in stock prices given the returns experienced in the third quarter and will there be enough upside to continue to propel the market higher, in front of an uncertain holiday season and a shift in the calendar year to 2010.

Only time will tell. What we do know, however, is that there is a tremendous amount of cash parked on the sidelines. According to a recent Bloomberg article, investors have cash positions equal to 73% of the S&P Index companies' net assets, equating to $9.55 trillion as of September. With cash hoards of this magnitude, re-investment of the cash alone could be the catalyst to keep the market moving higher, with or without further improvements on the economic front.

Portfolio Review

Risk assets remained desirable as evidenced by the continuation of the "low quality rally" that began in March of this year. Low quality, as it is being referred to, are those companies with sub-$5 share prices, the smallest market capitalizations and lowest return on equity. While this subgroup of stocks has continued to outperform the market overall, the variation in performance among the index constituents narrowed during the third quarter, as illustrated in the charts below.

§ **Performance by Market Cap – stocks over $1 Billion are lagging behind**
(Source: Bank of America Merrill Lynch)

Market Cap Bucket	R2G 3Q Return	R2G 2Q Return
>1 BILLION	**13.27%**	**10.63%**
>500 MIL, <=1 BIL	15.05%	23.82%
>250 MIL, <=500 MIL	20.25%	31.65%
<=250 MIL	**20.08%**	**48.74%**

§ **Performance by stock price –** (Source: Bank of America Merrill Lynch)

Stock Price	R2G 3Q Return	R2G 2Q Return
<=5	**35.00%**	**47.91%**
>5, <=10	20.49%	37.66%
>10, <=20	17.30%	24.72%
>20	**10.88%**	**13.04%**

§ **Performance by P/E quintile –** (Source: Bank of America Merrill Lynch)

P/E Quintile	R2G 3Q Return	R2G 2Q Return
Q1 (lowest)	**19.95%**	**44.88%**
Q2	15.94%	26.21%
Q3	13.26%	19.39%
Q4	10.50%	13.66%
Q5 (highest)	14.79%	18.25%
Non-earnings	**22.95%**	**33.38%**

§ **Performance by ROE quintile –** (Source: Bank of America Merrill Lynch)

ROE Quintile	R2G 3Q Return	R2G 2Q Return
Q1 (highest)	**14.59%**	**19.05%**
Q2	12.60%	21.10%
Q3	11.58%	24.05%
Q4	19.15%	29.25%
Q5 (lowest)	**26.42%**	**32.95%**

§ **Fastest Growers underperformed again** (Source: Bank of America Merrill Lynch)

Long term EPS Growth	Russell 2000 Growth 3Q 2009	Russell 2000 Growth 2Q 2009
<=10%	**17.16%**	**21.14%**
>10%,<=20%	15.50%	22.78%
>20%	**12.30%**	**20.75%**
NA	19.57%	30.40%

After a challenging second quarter, relative performance during the third quarter improved. While market conditions remain challenging as discussed above (i.e. the low quality rally has continued), Emerald was able to outperform the benchmark during the quarter, as a result of stock selection which resulted in better than index performance within technology, materials, consumer staples and consumer discretionary.

The technology sector continues to be the greatest contributor to portfolio return. While absolute returns within the technology sector lagged those achieved in energy, consumer discretionary and materials sectors, technology returns have continued to outpace the benchmark overall. Within the portfolio, technology sector performance was a positive contributor to return driven primarily by the portfolio's relative overweight position and positive stock selection within software and semiconductors. Holdings within the software industry rebounded aggressively during the third quarter as earnings results and guidance were generally better than expected, driven by a sequential acceleration in enterprise spending. The technology sector remains a focal point and represents the portfolio's largest relative overweight position.

Notable outperformance was also achieved within the materials sector. After disappointing relative performance in the second quarter, performance improved this quarter, driven by stock selection and an increase in the portfolio's relative overweight position. The portfolio has maintained it relative overweight position within materials.

In the Consumer Staples sector, Emerald significantly outperformed the benchmark. Emerald maintains its positive outlook for each of the core positions in the sector as we expect them to realize strong growth in earnings, both in absolute terms and relative to the sell-side consensus estimates.

Performance within the consumer discretionary sector also contributed positively to return this quarter. The portfolio also experienced better than index performance within casinos and gambling and diversified retail. The portfolio is currently equal-weight consumer discretionary.

Performance in the areas mentioned above was partially offset by weakness within the healthcare and producer durables sectors. Emerald has been underweight both of these sectors for the majority of 2009. While portfolio positioning has been directionally correct given the relative underperformance of these sectors, stock selection has not contributed to the magnitude needed to outperform. Stock selection was particularly disappointing within healthcare. While the portfolio's tilt toward the biotechnology industry was the correct one, given the outsized performance achieved in the industry relative to the sector overall, holdings within biotechnology did not perform to expectations during the quarter. The portfolio remains underweight healthcare.

In the case of producer durables, portfolio performance was negatively impacted by the portfolio's underweight position relative to the benchmark particularly in the aerospace and commercial services industries, as stock selection was neutral.

While the portfolio at quarter end remained underweight, Emerald has been selectively adding to its exposure, with recent portfolio additions falling within the commercial services and machinery industries.

While the dynamics of this rally have certainly presented challenges, relative performance improved during the third quarter and Emerald believes this is the part of the cycle where fundamentals should garner more focus, breadth should narrow and earnings growth should be rewarded. Portfolio positioning continues to favor technology and materials as these two sectors represent the largest relative overweight positions.

Outlook

The market advance experienced from the March lows has been nothing short of extraordinary. With the full faith and credit of the U.S. Government standing behind the financial system through programs such as TARP, TALF, and the huge stimulus, p/e multiples have expanded rapidly. While the political debate will go on for years over the bailout aspects of the program, there is no doubt that the Government backstop served its purpose to enhance confidence and encourage risk-taking. As a result, the capital markets reopened, enabling financial institutions to shore up capital positions and meet those all-important Tier 1 ratio requirements. With the banks stable, the market was able to establish a beachhead from which to move forward.

Second quarter earnings results were received extremely well by the market. Upside to estimates was driven by Corporate America's unprecedented expense reductions. Third quarter earnings results should be equally as strong. However, as expense reductions have been an acceptable driver of earnings to date, revenue growth will be the next driver of upside in the market.

So we come back to the same question in terms of the market's direction. The positives remain abundant. The capital markets are open and companies across all sectors (banks, small health care companies, technology and consumer) have been aggressively raising cash, through both equity as well as debt offerings as credit spreads compress. In fact, the bond market has now replaced the banks as the leading provider of debt capital to Corporate America.

Further, as discussed above, merger and acquisition activity has accelerated in recent weeks, and Emerald believes this could provide a new leg of growth for the market. Increasing confidence in the executive suite, as evidenced by the surge in acquisitions, should bode well for spending in 2010. We expect technology will be a beneficiary of higher spending levels, as companies look to improve productivity and service levels. Morgan Stanley's recent chief information officer survey revealed intentions for a 2% increase in spending in 2010; Emerald believes that could prove conservative if revenue growth begins to materialize.

All of these factors leave us with a short-term positive bias. Longer-term, however, there are plenty of negatives that loom on the horizon.

- The expiration of the Bush tax cuts.
- The implementation of healthcare reform.
- The dollar's continued devaluation. While a positive in the short-term in terms of promoting foreign sales for multinational companies, the long-term weakness ultimately will restrict investment in the U.S. and lead to inflation.
- The outlook for the newly owned government entities such as banks, autos, and insurance companies. Will they be able to free themselves from government ownership or simply limp along, unable to compete, unable to repay TARP, leaving a noose around the neck of the government and an enduring sign of capitalism's excesses?
- Inflation. While certainly a possibility longer-term, we do not believe it is an issue in the short-term considering the status of housing and employment. We have yet to relieve the market of deflationary forces and have to see the end of these problems and the current cycle before the problems of the next cycle will surface.

Despite these longer-term concerns, Emerald remains positively biased in the short-term as we believe the market will likely continue to move higher buoyed by better than expected earnings, continued merger and acquisition activity and fund flows which we believe will remain positive as the tremendous amount of cash, earning little to no return, that is sitting on the sidelines rotates back into the market.

-*October 26, 2009*